

8/3/92

STATE OF MINNESOTA
DEPARTMENT OF REVENUE

Proposed Rules for the Apportionment of
the Net Income from Television and Radio
Broadcasting.

**STATEMENT OF NEED
AND REASONABLENESS**

This document has been prepared as a verbatim affirmative presentation of the facts necessary to establish the statutory authority, need for and reasonableness of the proposed new rule. It is submitted pursuant to Minnesota Statutes, section 14.23, and Minnesota Rules Part 1400.0500 requiring a Statement of Need and Reasonableness.

Effect on Small Business

In preparing these proposed rules, the Commissioner of Revenue has considered the effect on small business. It is the commissioner's considered opinion that the adoption of the rule will not have an adverse effect on small business. On the contrary, the rules should be beneficial to small broadcasters who are not entitled to apportion income. Under the primary formula, Minnesota Statutes, section 290.191, subdivision 2, broadcasters whose only activity in other states is beaming signals into those states are not entitled to apportion income. Consequently, these broadcasters are taxed on 100 percent of their income by Minnesota. The rule makes it clear that such broadcasters would be entitled to apportion income and pay tax to Minnesota on only a portion of their taxable net income. Those broadcaster who do not beam signals into other states and have no other presence in other states are not affected by the rule. Their taxation by Minnesota remains the same.

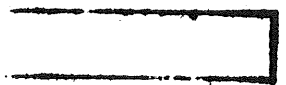
The Commissioner of Revenue has considered Minnesota Statutes, section 14.115, subdivision 2 in proposing this rule.

a) The establishment of less stringent compliance or reporting requirements is not feasible because these requirements are statutory. The method for determining the audience factor in subpart 10 is generally available to the entire broadcasting industry.

b) The schedules and deadlines are again statutory.

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- c) The compliance and reporting requirements are again statutory. The time for filing corporation income tax returns is fixed by statute.
- d) There are no design or operational standards in the rule.
- e) Since small business in Minnesota will benefit from the rule, there is no need to exempt small business from the requirements.

General Statement

Television and radio broadcasting is a unique business requiring a special apportionment formula. The broadcasting business depends upon advertising receipts for its income. The primary business activity that generates advertising income for broadcasters is the delivery of programming into states for viewing or listening by audiences. Of course, at the same time, the commercial advertising for which the broadcasters are compensated is also delivered into states.

The broadcasting industry is also unique in that communication satellites are used to transmit electronic signals across state lines. Because the satellites are positioned in outer space, they are not easily identified with any particular state.

Minnesota Statutes, section 290.191, subd. 2 provides that trade or business conducted both within and without Minnesota must apportion net income by use of a formula consisting of:

- a) 70 percent of the percentage of the sales made within this state are of the total sales made everywhere.
- b) 15 percent of the percentage of the tangible property used within state is of the total tangible property wherever located.
- c) 15 percent of the percentage of the payroll within this state is of the total payroll.

The elements in the generally applicable formula do not properly fit the business of the broadcasting industry because of the unique and complex way that the industry generates income and the unique location of some of the tangible property used in the business.

Minnesota Statutes, section 290.20 provides that if the primary formula, stated above, does not fairly reflect net income assignable to Minnesota, the Commissioner of Revenue may require the use of another method. The formula in the proposed rule is patterned after a rule recommended by the Multistate Tax Commission. 2 The Multistate Income Tax Guide, CCH ¶8400 (1990).

Minnesota has adopted the Multistate Tax Compact Act and is a member of the Multistate Tax Commission. Minnesota Statutes, section 290.171. The Minnesota version of the Multistate Tax Commission formula differs in two respects. First, the Multistate Tax Commission recommended regulation uses an equally weighted formula of property, payroll, and sales. The proposed rule, however, weights the sales factor 70 percent and property and payroll each 15 percent, in accord with legislative determination that a weighted formula be used in this state. Second, the Multistate Tax Commission recommended regulation contains an alternative provision that the audience participation element in the sales factor may be determined on a population ratio. This provision has been eliminated from the Minnesota rule since it is our opinion that it could produce inaccurate results.

Subpart-by-Subpart Analysis

Subpart 1 provides the statutory authority for requiring a special formula for certain industries or businesses.

Subpart 2 lists the definition of terms used in the proposed rule.

Subpart 3 cross reference the statute so that sales are weighted 70 percent, payroll 15 percent, and property 15 percent.

Subpart 4 sets forth the method for determining the net annual rentals to be used for valuing leased property. Generally, rentals are capitalized at eight times to determine the value of leased property in the hands of a lessee. The subpart also eliminated film and radio programming from the property factor.

Films and radio programming property have both the characteristics of tangible and intangible property. Historically, only tangible property has been included in the property factor because of the difficulty of attributing a fixed location to intangible property. Furthermore, since films are displayed across state lines, it is difficult to ascertain the extent of use in a particular state.

Subpart 5 sets forth the rules for the property factor denominator. All real and tangible property of the broadcaster is included in the property factor denominator with the exception of outer-jurisdictional property and film or programming property.

Outer-jurisdictional property includes property such as orbiting satellites and undersea transmission cables that are not located in any particular state. Under the Minnesota statutory formula and the apportionment formulas of

other states, tangible property is attributed to the state in which the property is used and located. If outer-jurisdictional property would be included in the property factor, it would be necessary to fractionalize the value of such property among the states. We know of no acceptable method of obtaining the proper fraction for inclusion in each states' numerator of the property factor.

Apportionment formulas need to be easily administered. To fractionalize the outer-jurisdictional property would unnecessarily complicate the formula.

Subpart 6 includes the same type of property in the numerator of property factor which is used in this state during the tax year. In addition, the rule provides for the inclusion of property which is in this state for only part of the year on the basis of ratio. The ratio is needed because broadcasters move property into a state for selected special programming.

Subpart 7 describes the payroll factor denominator which deviates from the statutory payroll factor by allowing compensation paid to independent contractors for services to be treated as employee compensation if the commissioner finds excluding such compensation will not fairly represent the taxpayer's business activities within this state. Broadcasters do employ independent contractors to perform services that are also performed by employees.

Subpart 8 provides that the numerator of the payroll factor shall be determined according to the statute. The compensation paid to independent contractors which is included in the denominator of the payroll factor under subpart 7 will also be treated as employee compensation in the numerator as required by the statute for other employee compensation.

Subpart 9 follows the statute by including all gross receipts from transactions in the regular course of the taxpayer's trade or business.

Subpart 10 describes the sales factor numerator which should reflect the market for a taxpayer's goods or services. See Miller, Benjamin F., *The State Corporation Income Tax: Worldwide Combination, the California Process* (Hoover Institution Press 1984), page 135. An audience share ratio has been introduced into the numerator of the sales factor to reflect the market for the broadcaster's services. Without an audience, broadcasters would not realize advertising revenue. An audience factor better accommodates the economic realities of the broadcast industry, than assigning revenues to the state where the advertising contract is negotiated. In Metromedia, Inc., v. Director Division of Taxation, 97 N. J. 313, 478 A. 2d 742 (1984), the Court decided that it was

reasonable to include an audience share factor in the apportionment formula of interstate broadcasters, but held that the factor must be adopted by rule under the Administrative Procedures Act.

Most network programs which include advertising originate in either New York or California. Both New York and California have adopted an audience share ratio in apportioning the income of broadcasters. See 1 N.Y. State Tax Reporter, CCH ¶6-127, 1 Cal. State Tax Reporter ¶14-834 H (1990). Since the states where commercial network broadcasts originate currently use an "audience factor," it is only appropriate that states where the recipients are located also use an audience factor to fairly tax all but not more than all of the income.

The formula in the proposed rule also meets constitutional tests laid down by the United States Supreme Court in Container Corporation of America v. Franchise Tax Board, 463 U.S. 159 (1983), that an apportionment formula be internally and externally consistent. The formula in the proposed rule is internally consistent because if adopted in all states, no more than 100 percent of the income of a broadcaster would be taxed. The proposed formula is externally consistent because the factors used reflect a reasonable sense of how income is generated "by a broadcaster." Without the delivery of commercial messages to a viewing audience, broadcasters would not generate advertising revenue.

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